

“Custodian Bank”: India Adopting Global Standards

The Announcement!

The First Bi-monthly Monetary Policy Statement, 2016-17 by Dr. Raghuram G. Rajan, Governor of Reserve Bank of India on 5th April 2016, while proposing many forward looking changes- carried in Point 29 of part II (Banking Structure) of Part B: Developmental and Regulatory Policies II the need to explore possibilities of licensing other differentiated banks **such as custodian banks**” A paper is expected to be put out for comments by September 2016. **This is welcome news!**

This step will integrate Indian Capital Markets, increase efficiency, enable greater straight through processing and more importantly establish a level playing field between the Universal Banking set ups who also engage in Custodial Services(read Securities Services) and Institutions specialising in Custodial Services(read Securities Services). The concept of Custodian Bank is not new Internationally. Introduction of Custodian Bank will mean India adopts yet another global standards and processes.

PIVOT in Jan. 2016 advocated need to have Custodian Banks in India(article in LinkedIn)

Indian Capital Markets over 2.5 decades evolved rapidly and together with digital and other developments in the Banking Sector addressed many a risk related issues as well as inefficiencies. Adopting Global standards, best practices increased investors confidence- of local and Inflow.

The Government of India and Regulators(SEBI and RBI) have continually implemented initiatives for attracting foreign investments(Digital India, Make for India, developing world class infrastructure etc.). In recent times, the introduction of FPI Regulations, DDP, uniform KYC and Payment Banks can be considered as significant developments in the Capital Market and Banking.

In the Union Budget of 2014-15 the Hon’able Finance Minister advocated the need to create a framework for licensing small Banks and other differentiated Banks. The Reserve Bank responded swiftly introducing the concept of Payment Banks and Small Banks, developing guidelines and awarded licenses to successful applicants. The announcements in the Monetary Policy Statement, 2016-17 is a step forward.

Development of the Custodian Segment in Capital Markets:

Global Framework

Custodians in the Securities Market play undertake a number of Clearing and settlement related, Banking, regulatory compliance activities on behalf of Institutions, corporates, FPIs, Mutual funds, PE,FDI’s etc.

Globally the Custodial framework is comprised of two sets of service provider:

- 1) Universal Banking Custodians – Primarily Banks that engage in multiple segments-local/ cross border and
- 2) Custodian Banks also referred to as Limited Purpose Banks

Typically, the above Listed Custodian Category render similar Banking and Capital Markets settlement activities, except for the fact that Custodian Banks typically confine their activities related to Capital Market while Universal Banks also service non- Capital Market segment as well as Non- Institutional segment. Globally “Custodian Banks” exist in all developed markets and most of the emerging markets.

Some of the leading Custodians in the world are:

The Bank of New York Mellon; State Street Bank and Trust Company; JPMorgan Chase; Citi; BNP Paribas; HSBC; Standard Chartered; Northern Trust; Brown Brothers Harriman

The Bank of New York Mellon, State Street Bank, Brown Brothers Harriman, Northern Trust, are Custodian Banks whereas Citi, BNP Paribas, HSBC etc are Universal Banks.

India Framework:

Approximately 65% of India’s market capitalisation of USD 2.1 trillion is comprised of Institutional Holdings. This space is growing rapidly. SEBI and RBI recognised the importance of Custodians in 1988. Stock Holding Corporation, India’s’ largest Custodian(a non Bank Custodian) was the first Custodian to be granted license by SEBI. Presently 19 Custodians are recognised by SEBI. Other Non- Custodian Banks include Orbis, ISSL.

India's Custodial framework broadly comprised of two sets of service provider:

- 1) RBI registered Universal Banks (Global/Indian) providing SEBI registered Custodial Services
- 2) SEBI registered Non Bank Custodians (unique to India).

The Non-Bank Custodian framework in India is not consistent with practices that exist in advanced and emerging markets. Ironically India till the First Bi-monthly Monetary Policy Statement, 2016-17 did not recognise the "Custodian Banks".

Role of Custodian Bank in India:

1. Integrated services

Custodian Bank would offer cash management and foreign exchange transaction services and thus be as an integrated service provider catering to multiple requirements of the clients/segments

2. Easing entry of investors which have regulatory hurdles to entry India

A few jurisdictions do not permit institutional investors registered in that country to maintain securities with Custodians that do not have Bank Status. The change potentially enables Inflows into India.

3. Level playing field

Universal Banks Custodians have an advantage in attracting FPIs due to their Banking status. Permitting Custodian Banks, increases the no's of providers leading to competitive Custodial services.

4. Encourage all types of Foreign Portfolio Investors

SEBI's FPI Regulations, 2014 enabled Category III investors to invest in India. Category III investors mostly comprise of small corporates, family offices, individuals, etc. They generally do not form "target segment" of Global Universal Banks Custodians, but could be potential clients of Custodian Banks. This potentially enables inflows into India.

5. Making Domestic Player more attractive for tie-ups

Global Custodians Banks as Bank of New York, State Street Bank etc do not have India presence and mostly use Foreign Universal Custodians as their Sub-Custodians. If Custodian Bank services are enabled, the Global Custodians may consider tie-up with domestic Custodian Banks.

6. Administrative problems

Currently Non- Bank Custodians in India maintain Multiple Banking relationship. Collecting the funds from various Banks, remitting them to the Clearing Corporations crediting the accounts of the clients in different Banks results in enormous administrative work causing unavoidable delays and costs. These extra steps can be eliminated

7. Reduce , Streamline AML and KYC documentation requirements

The introduction of Custodian Bank will lead to reduction in the documentation requirements as the documents will be required by a single entity vs the non- Bank Custodians.

8. New opportunities

RBI has allowed the Indian investors to invest abroad. Some of the Indian Mutual Funds have invested in other jurisdictions. Custodian Banks can meet the requirements of such mutual funds through tie ups with overseas providers of custodial and Banking services.

9. Encourage entry of Global Custodian Banks

Enabling "Custodian Banks" may encourage Global Custodian Banks to enter India and offer Custodian services. Their entry may bring more competitiveness in the service offerings to the benefit of the Investors.

“Custodian Bank” in India, may render the following functions:

a) Cash Management Activities

Custodian Banks would offer cash management services including opening, maintaining and servicing of client’s current account, issuing demand drafts and pay orders to clients, remittances on behalf of clients, participation in clearing functions, transfer/remittance of funds and maintenance of credit balances incidental to securities transactions.

Custodian Bank may provide MIS relating to the client’s integrated cash and custody positions, incorporating settlement flows and incomes from dividend and interest. Being privy to the client’s custody positions, the Custodian Bank will be able to provide its clients with up to date positions on the cash received. This will enable the client to engage in effective Treasury Management.

b) Authorised Dealer- Category 1 Bank status to facilitate Foreign Exchange Operations

The Custodian Bank would seek an Authorised Dealer Category -1 licence (AD 1). It will maintain Nostro accounts, enter into spot and forward exchange contracts with clients, take part in International Settlements and funds transfer through SWIFT. It may establish correspondent Banking relationships.

c) SGL account for its clients

Custodian Bank may offer SGL services to its clients for investments in Government debt a growing segment in India.

d) Settlement Banker for Clearing Corporations

Currently, non-Bank Custodians route settlement flows to the Clearing Corporations through another Banker which acts as the settlement Banker. In the new scheme the Custodian Bank could act as settlement Banker for its clients resulting in savings in terms of transaction cost and greater STP.

e) Comprehensive integrated reporting to regulators

Custodian Bank would be in a position to meet with regulatory requirements(especially banking) on its own rather than relying on other service providers.

Benefits of permitting “Custodian Bank”

Institutions that would be permitted as Custodian Banks would assume - greater accountability, higher level of straight through processing, higher degree of risk management, lesser external dependability, lower costs, consolidated AML and KYC documentations, higher transaction confidentiality, greater control and compliance, Regulatory reporting. Custodian Bank may also provide focussed and comprehensive services to Investors while reasonably mitigating their risk vs those as is in the case of Universal Banks.

Conclusion

Besides attracting Global Custodian Banks it will also facilitate India based present Non-Bank Custodians to participate actively in servicing all classes of investors effectively. India would also benefit from moving away from the unique and self-defeating Non-Bank Custodian Framework, to the globally accepted Framework of Custodian Bank. Investor confidence and acceptance(local/foreign) will potentially increase.

The conversion of Custodians into Custodian Banks, guided per RBI Regulations, under the new “Niche Segment Banking” will benefit the Investors, develop capital market infrastructure, develop the Institutions offering Custody, minimize risks, promote greater Straight through processing, usher competition and best practices. It will also complement the “Ease of doing business in India” with “Ease of investing in India. Thus there exists a strong case in enabling Custodian Banks. **PIVOT will be glad to share detailed listing of the potential benefits with the readers.**

THE RBI ANNOUNCEMENT IS A WELCOME STEP!